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Raising the Minimum Wage and Derailing the Great American Jobs Machine

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Despite the more than eleven million jobs created since 1982, there is a concerted effort afoot to portray the past four years as a period of decline and harship for U.S. workers, and their future as exceedingly bleak. Through an expensive television advertising campaign, organized labor has identified the source of this misery as low-paying service sector jobs. The message is that, in order to avoid a dismal future, we must instruct our elected representatives to "do something" to turn around the trend towards low-paying jobs. That "something" is defined as raising the minimum wage. But as this study will show, raising the minimum wage will reduce employment and increase inflation.

A Political Agenda

The premise--that the newly created service sector jobs are low-paying, dead-end jobs--is false. Nevertheless, it is the basis of a political agenda designed to portray its advocates as patriotic, compassionate Americans dedicated to protecting the besieged American worker. The empirical and historical evidence, however, show that the solution being proposed--raising the minimum wage--will result in lower employment and higher prices. It is, however, likely to preserve union jobs and protect union earnings at the expense of everyone else.

The drive towards raising the federal minimum wage derives some of its support from the notion that the increase in employment of the past four years has been concentrated in low-paying, dead-end service sector jobs. This allegation is found in a recent and well publicized study for the Joint Economic Committee of Congress by Barry Bluestone and Bennett Harrison, which purports to show an alarming increase in low-paying jobs during the period 1979-1984. According to the authors, "...nearly three fifths of the net new employment generated between 1979 and 1984 was low wage, compared to less than one fifth during the preceding period [1973-79]." 1/

But, as economics writer Warren T. Brookes has since discovered, their analysis contains serious errors of which the authors were aware. Bluestone

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and Harrison arrived at inflation-adjusted wages by using the consumer price index (CPI) as a "deflator." However, the use of the CPI as an adjustment factor understates constant dollar wage scales. When the data was adjusted for inflation using the deflator for personal consumption expenditures as an adjustment factor, "...most of the low-pay trend disappeared." 2/ Another statistical error was the choice of years. Bluestone and Harrison arrived at their conclusion by comparing the period 1973-79 to 1979-84. This choice amounts to a comparison of two extremes and essentially credits Reagan with Carter's worst two years. JEC economist Christopher Frenze found that, if instead of comparing the years 1973-79 to 1979-84, we look at the data for the entire period 1973-85, "...there is almost no change in the distribution of jobs by pay classification, even accepting the Bluestone-Harrison data base with its disputed deflator." 3/

The Bluestone-Harrison study was intended to discredit the Reagan Administration's economic success. However, as Mr. Brookes points out, the years 1979-84 contain "...three Carter fiscal years that also included two recessions, the worst inflation in modern history and a massive...decline...in average real wages." 4/ But if the data is arranged to match each of the four-year presidential budget cycles, the numbers show just the opposite, namely, that during the Reagan years (1981-1985) the proportion of net new jobs created in the high-paying category ($28,048 and over) was 46 percent, compared to a 10 percent loss of such jobs during the Carter years, and a 6 percent loss during the 1979-84 period studied by Bluestone and Harrison. Moreover, the respective shares of low-paying jobs created were 6 percent during the Reagan years, 42 percent during the Carter years, and 58 percent in 1979-84. 5/ Contrary to what is implied by the Bluestone-Harrison study, the only conclusion that stems from the data is that the overwhelming majority--92.3 percent--of the net new jobs created during the Reagan Administration were in the middle- and high-paying categories.

Despite the fact that the allegations regarding the trend towards low-paying jobs have been shown to be wrong, they have become the basis for proposals to increase the statutory federal minimum wage in an effort to alleviate poverty and raise the standard of living of low-wage earners. This proposal is the economic equivalent of cutting off one's nose to spite one's face--a higher minimum wage reduces employment and increases inflation, leaving everyone worse off in the process. Increases in the federal minimum wage will especially hurt those vulnerable, unskilled workers who are priced out of the market and cannot find jobs at the higher minimum wage.

Oddly, the proponenets of raising the minimum wage couch their argument in welfare terms, insisting that since the last time it was increased, the minimum wage has been eroded by inflation, and that it has not kept pace wih increases in average hourly earnings in other sectors. This is indeed true. However, before deciding that raising the minimum wage will reduce poverty and raise living standards, it must first be establish who the minimum wage earners are.

Minimum Wage Earners Are Not Poor

The main thrust of the argument for raising the minimum wage is that doing so will raise earnings of low-income workers and reduce poverty. This

reasoning, however, completely ignores the fact that only one-fifth of all minimum wage workers are classified as living below the poverty line. Moreover, more than 89 percent of the households below the poverty line would not see any change in their status if the minimum wage were increased. While this assertion may be surprising, it follows from what we know of the characteristics of minimum wage workers; namely, their youth and inexperience: 60 percent of minimum wage earners are under twenty-five years of age. In addition, two-thirds of them are part-time workers. Most minimum wage workers are teenagers who belong to households with an employed adult and income above the poverty line. In many instances, they are second or even third earners in the household. To those young, inexperienced workers, minimum wage jobs are an extension of schooling since those jobs offer them the training and the work experience to move on to higher paying jobs. The minimum wage deprives the youth of America, not only of the opportunity to get a job, but also of the needed experience and on-the-job training, while it does nothing to alleviate poverty.

Indeed, the major problem faced by those with incomes below the poverty level is not inadequate income for time worked, but the lack of a year-round job. Nearly half of the families below the poverty level did not have any family member employed. In effect, raising the minimum wage will do nothing to lift these people out of poverty, but it will further hinder their chances of finding employment and increase hardship since higher labor costs brought on by a higher minimum wage will raise inflation and lower overall economic activity.

Economic Effects of Raising the Minimum Wage

Ever since the Fair Labor Standards Act (FLSA) of 1938 instituted a federal minimum wage, numerous studies have shown that, contrary to its stated purpose of raising wages "without substantially curtailing employment," increases in the minimum wage do, in fact, reduce employment below the level that would prevail in the absence of such increases. While the stated aim of the legislation--raising the level of income of those employed at the minimum wage--may be attained, this is accomplished at the expense of other minimum wage workers who, at the higher minimum, become unemployed.

Increases in the minimum wage affect the economy by simultaneously reducing employment and raising inflation from the levels that would have prevailed in the absence of the increase. While the initial impact is felt by employers, particularly those in low-wage industries, whose wage bills rise with the higher mimimum, the increase in labor costs is not confined to low-wage industries or workers. When the minimum is raised, employers find it necessary to raise the entire wage scale to maintain wage differentials between employees with different kinds of skills. Thus, an increase in the minimum wage generally leads to a ripple effect of compensatory wage increases throughout the economy. A 1977 survey of small business reactions to the then-pending minimum wage increase found that 82 percent would have to increase wages of above-minimum employees to maintain the previously existing spread in wages of employees with different kinds of skills. 6/

Usually, businesses will deal with the increase in labor costs resulting from the higher minimum by either (1) passing the burden on to consumers in the form of higher prices and/or curtailed services (e.g., no longer provide free delivery services, etc.); (2) absorbing the added costs by reducing profit margins; or (3) passing these costs along to the workers themselves by reducing the numbers of hours worked, reducing the number of employees, freezing new hiring, or requiring that workers earn their increased wages through added work effort. In 1977, prior to the last increase in the statutory minimum wage, a survey of small businesses discovered that the previous time the federal minimum wage was increased, operating costs rose between 1 and 10 percent for 65.4 percent of the small businesses surveyed. In order to deal with the higher costs, 62.7 percent of the respondents said that they had raised prices between 1 and 10 percent, and 45.8 percent said that they absorbed costs by cutting into profit margins. But, these businesses also held the line on wage costs by reducing the number of hours that each employee worked per week (53.3 percent reported doing this), reducing the number of employees (47.6 percent), and freezing the hiring of new employees (81.3 percent). 7/

Thus, the first impact of a higher minimum wage is lower levels of employment and higher inflation. But this is just the beginning. Increases in the minimum wage cause other economic distortions which reverberate through the economy, thus reducing overall economic efficiency. A typical reaction to higher labor costs is the substitution of highly skilled workers and labor-saving machinery for low skilled workers. During the 1977 survey, 47.9 percent of the respondents said that they anticipated investing in labor-saving machinery or equipment if the minimum was raised (as it later was). 8/ This increase in the capital/labor ratio increases productivity and mitigates the initial inflationary impact of the higher minimum. But this forced substitution of capital for labor also leads to more unemployment.

These induced shifts in employment, earnings and productivity affect national income and aggregate demand, prompting firms to adjust production. Despite the increase in the minimum wage, the lower level of employment results in lower earnings. In addition, the rise in inflation, albeit tempered by the rise in labor productivity, reduces consumer purchasing power. Higher costs raise inflationary expectations, translating into a higher risk premium on interest rates. Higher interest rates depress activity in interest-sensitive sectors such as housing, automobiles and consumer durables. As a result, consumer spending declines, and as production adjusts to the lower levels of demand, investment and ultimately, real GNP also decline. This decline in overall economic activity is likely to cause a secondary wave of job losses until the economy settles at a level of activity which is lower than the one which would have otherwise prevailed.

The impact of a higher minimum wage is also felt in the international arena. Higher labor costs will have a significant negative impact on the international competitiveness of U.S. exports. Since 1982, U.S. manufacturers have operated at a disadvantage with respect to their foreign counterparts because labor costs were higher in the U.S. than abroad. For instance, between 1982 and 1985, hourly compensation of Japanese production workers was only half of the U.S. level. But since 1985, the declining value

of the dollar together with significant improvements in U.S. manufacturing productivity (thanks to moderate increases in labor costs), have improved the competitiveness of American manufacturing. As a result, Japanese compensation has risen to 79 percent of that in the U.S., and compensation of production workers in West Germany, which was 75 percent of the U.S. level in 1985, is now 120 percent when expressed in dollars. 9/ This improvement in the international competitiveness of American products, so important to increasing exports and reducing the yawning trade gap, will be eroded by the rise in labor costs and inflation.

Empirical Evidence

Estimates of the employment effects of a higher minimum wage emphasize the impact on the teenage population, which is disproportionately represented in minimum wage earners. Studies have found that a 10 percent increase in the minimum wage would reduce teenage employment between 0.5 and 3 percent, with most studies yielding results in the 1 to 2.5 percent range. In 1981, the Minimum Wage Study Commission found that a 10 percent increase in the minimum wage reduced teenage employment between 0.5 and 1.5 percent. 10/ Given a total employed teen population of 5.8 million, this latter estimate means that a 39 percent increase in the minimum wage, from the current $3.35 to $4.65 per hour as has been proposed, would result in a loss of between 113,100 and 339,300 teenage jobs.

Studies of the inflationary impact of a 10 percent increase in the minimum wage estimate that total prices would rise between 0.2 percent and 0.9 percent. The Minimum Wage Study Commission found that the sustained rise in the minimum wage from 1974 through the second quarter of 1979 caused an average increase in direct wages of 0.3 percent which after three quarters rose to 0.7 percent because of the ripple effect. Indirect effects on price inflation, productivity and unemployment boosted the total wage inflation effect to 0.8 percent. A 10 percent minimum wage hike increased consumer price inflation by 0.3 percent. 11/ The smaller increase in consumer prices is caused by the effect of rising productivity which mitigates the impact of higher labor costs, but this increase is not enough to entirely offset the inflationary effects of a higher minimum.

In order to arrive at an estimate of the dynamic effects of the increase in the minimum wage that was recently proposed by Senator Kennedy (D-MA) and Representative Hawkins (D-CA), we performed a policy simulation using the Washington University long-term macroeconometric model of the U.S. economy. The exercise involves a comparison of two alternatives: one in which the minimum wage is maintained at $3.35 per hour through 1995, and a second where the minimum wage is raised to $4.65 in three years and thereafter indexed to 50 percent of nationwide average hourly earnings. 12/

A comparison of the two alternative scenarios shows the expected harmful results (see table, p. 6). The higher minimum wage increases hourly compensation and unit labor costs, and lowers the number of hours worked. The increase in unit labor costs peaks at 3.3 percent in 1993, and by 1995, they are 3 percent higher than would otherwise have been the case. Higher costs reduce the demand for labor, reducing civilian employment by an average of 1.1 million jobs per year, or a cumulative decline of 8.5 million jobs between 1988 and 1995. The unemployment rate is not only higher than the base case scenario, but rather than

Economic Impact of Increasing the Federal Minimum Wage [1]

	1988	1989	1990	1991	1992	1993	1994	1995
Minimum Wage ($/hr.)								
Base	3.35	3.35	3.35	3.35	3.35	3.35	3.35	3.35
Alternative	3.85	4.25	4.65	5.72	6.07	6.41	6.76	7.14
Hours Worked (%) [2]	-0.09	-0.36	-0.73	-1.16	-1.62	-1.95	-2.05	-1.99
Hourly Compensation (%) [2]	0.57	0.95	1.30	2.22	2.52	2.62	2.53	2.44
Unit Labor Costs (%) [2]	0.00	1.25	2.44	2.33	2.25	3.26	3.13	3.00
Civilian Employment (mill.) [3]	-0.06	-0.25	-0.55	-0.91	-1.33	-1.69	-1.86	-1.89
Unemployment Rate (%)								
Base	6.93	6.53	6.44	6.33	6.34	6.37	6.19	6.08
Alternative	6.97	6.72	6.83	6.96	7.25	7.50	7.41	7.29
Difference [4]	0.04	0.19	0.39	0.63	0.91	1.13	1.22	1.21
Unemployment Benefits ($B) [6]	0.12	0.47	0.99	1.63	2.37	2.95	3.22	3.23
Consumer Price Index (%) [2]	0.24	0.50	0.67	1.06	1.26	1.28	1.25	1.19
Treasury Bill Rate (%) [4]	0.08	0.13	0.14	0.25	0.25	0.22	0.20	0.19
Equipment Investment								
Difference ($82B)[5]	-0.55	-2.43	-5.48	-9.15	-13.07	-15.96	-16.90	-16.21
Percent Difference (%) [2]	-0.16	-0.70	-1.57	-2.54	-3.52	-4.17	-4.26	-3.97
Output Per Hour (%) [2]	0.00	-0.11	-0.11	-0.21	-0.16	-0.05	0.05	0.10
Nominal Personal Income								
Difference ($B) [6]	9.51	16.09	19.51	34.66	35.06	33.04	33.24	35.01
Percent Difference (%) [2]	0.29	0.46	0.53	0.87	0.83	0.74	0.70	0.69
Real Personal Income								
Difference ($82B) [5]	1.68	-0.53	-3.50	-4.49	-12.13	-16.37	-17.27	-16.30
Percent Difference (%) [2]	0.06	-0.02	-0.12	-0.15	-0.40	-0.53	-0.55	-0.50
Real Consumption								
Difference ($82B) [5]	-1.31	-4.28	-10.31	-16.81	-24.50	-31.33	-35.96	-39.61
Percent Difference (%) [2]	-0.05	-0.17	-0.39	-0.61	-0.88	-1.10	-1.23	-1.32
Real GNP								
Difference ($82B) [5]	-4.23	-14.71	-28.01	-43.69	-60.02	-70.84	-72.92	-70.83
Percent Difference (%) [2]	-0.11	-0.37	-0.68	-1.04	-1.39	-1.60	-1.60	-1.51

[1] To arrive at an estimate of the dynamic effects of the increase in the minimum wage recently proposed by Sen. Kennedy and Rep. Hawkins, we performed two simulations of the Washington University model. The base case holds the federal minimum wage at $3.35 per hour through 1995. In the alternative simulation, the minimum wage is raised to $4.65 per hour in three stages as follows: to $3.85 in January 1988, to $4.25 in January 1989, and to $4.65 in January 1990; thereafter, it is raised annually to a level equal to 50% of average hourly earnings (see footnote 12).

[2] Percent difference from base case.
[3] Difference in millions of jobs.
[4] Percentage point difference.
[5] Difference in billions of 1982 dollars.
[6] Difference in billions of current dollars.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University long-term macroeconometric model of the U.S. economy.

declining during the eight-year period, it rises. By 1995, the civilian unemployment rate is 1.2 percentage points higher than would otherwise have been the case, and 0.3 percentage points higher than in 1988. The higher unemployment rate is reflected in federal outlays, particularly unemployment benefits which are $3.2 billion higher by 1995.

Consumer prices rise above the base case, and by 1993 the consumer price index is 1.3 percent higher. Higher inflation is reflected in higher interest rates, and by 1995 the interest rate on three-month Treasury bills is 19 basis points higher than under the baseline scenario.

The substitution effect on investment in equipment is overwhelmed by the lower levels of demand and economic activity. By 1995 the level of investment is significantly below what would have otherwise occurred. This, in turn, affects labor productivity (output per hour) which falls in five of the eight years. Ironically, while the higher levels of compensation raise nominal personal disposable income above what would occur in the absence of the rise in the minimum wage, the induced increase in inflation more than offsets this nominal increase, leaving real income lower. Thus, the proposed increase in the minimum wage will result in a cumulative decline in inflation-adjusted personal disposable income of $68.9 billion between 1988 and 1995, an average falloff of almost $9 billion per year. Consequently, consumer spending also suffers, and real GNP is $70.8 billion lower by 1995.

Conclusion

These findings should not surprise the reader as they corroborate more detailed findings in countless other studies. The evidence is incontrovertible. Nevertheless, the myth persists, and every few years legislators propose to enact yet another increase in the minimum wage. In the process they congratulate themselves for such a clear expression of their superior morality and compassion. Yet this exercise in easy ethics only leads to greater hardship for all Americans.

But if the overall impact is negative, why is it that periodic increases in the minimum wage are enacted? The answer lies in the fact that some groups do reap benefits from regulations whose overall impact on the economy is negative. In a study entitled "Union Wages and the Minimum Wage," published in June 1981 by the Minimum Wage Study Commission, Henry S. Farber found that "...while changes in the minimum wage may have a temporary and relatively minor effect on negotiated wage changes, the existence of a minimum wage which is set substantially above the market wage may fundamentally alter the distribution of alternative wages available to union workers. The result will be a higher union wage structure than would exist in the absence of a minimum wage, and, while the effects of such changes on union wage changes seem small, the discrete change implied by the existence of the minimum wage may have had a somewhat larger effect." 13/

This conclusion was corroborated in a 1982 study by Peter Linneman, which shows that "...union members gained substantially from the presence of a minimum wage law in 1974. The average gain [in expected earnings] for a union member exceeded $400, while nonunion members lost an average of $8.00 per person in earnings. Furthermore, while 85 percent of the members of labor unions were expected to gain from the imposition of the minimum, only 44 percent of the

nonunion population was expected to experience higher earnings in the presence of a minimum." 14/

* * *

Footnotes

1/ Barry Bluestone and Bennett Harrison, The Great American Job Machine, a study prepared for the Joint Economic Committee, December 1986, page 17.

2, 3, 4, 5/ Warren T. Brookes, "Low-Pay Jobs: The Big Lie," The Wall Street Journal, March 25, 1987.

6, 7, 8/ U.S. Chamber of Commerce, Center for Small Business, "The Effects of the Federal Minimum Wage on Small Business: Report of a Survey," September, 1977.

9/ Kenneth H. Bacon, "The Outlook: Shrinking Wage Gap Helping U.S. Firms," The Wall Street Journal, March 23, 1987.

10/ "The Employment and Unemployment Effects of the Minimum Wage," Report of the Minimum Wage Study Commission, Volume 1, Chapter 2, page 38.

11/ "The Impact of the Minimum Wage on Inflation," Report of the Minimum Wage Study Commission, Volume 1, Chapter 3, page 62.

12/ Because the Washington University model does not contain the particular earnings indicator that would be used as a reference for indexing the minimum wage, the variable "private nonfarm hourly compensation" (LCMHB) which is expressed in dollars per hour, was used as a proxy. LCMHB was adjusted as follows: It was determined that during the period 1964-1986 average hourly earnings averaged 73.37 percent of LCMHB. In order to establish the minimum wage in the years following 1990, therefore, we took 73.37 percent of LCMHB as a proxy for average hourly earnings, and 50 percent of that as the minimum wage.

13/ Henry S. Farber, "Union Wages and the Minimum Wage," Report of the Minimum Wage Study Commission, Volume VI, June 1981, page 131.

14/ Peter Linneman, "The Economic Impacts of Minimum Wage Laws: A New Look at an Old Question," Journal of Political Economy, Volume 90, Number 3, June 1982, pages 463-464.